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Riding the Dragon: Entrepreneurship under Market Transition

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ABSTRACT

This dissertation examines international entrepreneurship, with a particular focus on the mechanisms through which institution and social factors shape entrepreneurial behaviors in developing countries.

The first essay examines the causal mechanism of social ties in venture financing. A staged model is developed to show that network has a limited yet powerful effect.

The second essay examines the institutional driver of entrepreneur's foreign direct investment (FDI) seeking behavior. While diluting ownership controls, FDI helps local entrepreneurs to overcome the constraints imposed by China's political pecking order.

The third essay examines the role of bureaucratic legacy upon entrepreneurial performance. I find that Chinese entrepreneurs who worked in the public sector have better access to state controlled resources but low efficiency in utilizing them.

Riding the Dragon: Entrepreneurship under Market Transition

Yanbo Wang

My dissertation's title, "Riding the Dragon", refers not only to the empirical context, namely China, that I am examining, but also to the various opportunities and risks that private entrepreneurs face in transitional economies. On the one hand, the legacy of "shortage economy" (Kornai 1992) has created many unfulfilled market niches in former socialist countries. Taking advantages of these opportunities, successful entrepreneurs often grow their ventures at a skyrocketing speed. On the other hand, transitional economies are often characterized with underdeveloped market supporting institutions and entrepreneurs often fall victims to the government's "grabbing hands" (Shleifer and Vishny 2002). From these perspectives, entrepreneurship under market transition is exactly like riding a dragon - while one may rise high and fast, he may also fall down quickly in a hard way! Thus, studying the various strategies that economic actors adopt to overcome institutional voids has important implications for international entrepreneurship, both theoretically and practically.

My choice of China is based on its obvious significance in the world economy and that I have a wealth of personal and research experience. Born in the last year of the Cultural Revolution, I was raised in the reform years. I have personally witnessed how the lives of billions have been changed and what a central role that entrepreneurship has played in the process of China's transition. At the same time, I have also witnessed many entrepreneurs whose ventures failed due to governmental policies that were originally designed to make a positive change in the economy. I wish that my study will shed light on our understanding of dynamics of entrepreneurial activities in China and help both the decision making of (potential) entrepreneurs and policy makers in China and beyond its national border.

My research has two main themes. The first one examines the impact of social ties on entrepreneurial success. My goal is to reveal the various tradeoffs that individuals have to make when their economic actions are embedded in social relationships. The second theme looks at how institutional factors shape entrepreneurial behaviors and performance. My goal is to show how well-intentioned policies may create economic distortions that motivate entrepreneurs to adopt nonmarket strategies. Even though I look at the traditional sectors as well, my main focus is on China's high-tech firms and the quickly emerging venture capital industries. These sectors are the most knowledge-intensive. These sectors are not only the new engine of economic growth in China but also are shaping the global landscape of technology innovation and competition. In the section below, I briefly outline my research.

Social Networks for Developing Economy Entrepreneurs

In "Evaluation or Attention: How do Social Ties Matter in Venture Financing", I examine high-tech firms' pursuit of venture capital (VC) to understand the mechanisms through which social networks influence the decision-making process of resource holders. In particular, while prior research has found a positive correlation between social ties with VCs and entrepreneurs' access to capital (Shane and Cable 2002; Batjargal and Liu 2004), these studies conflate the evaluation of entrepreneurs with the necessary preceding act of becoming aware of them (Coleman, Katz, and Menzel 1966; Van den Bulte and Lilien 2004). My research challenges the established wisdom, arguing that while better-networked entrepreneurs are advantaged in terms of getting the initial attention of investors, this advantage does not carry over to the next stage of evaluation. By collapsing the two stages together prior studies have come to erroneous conclusions about the role of social networks.

Disentangling these two stages empirically raises a key inferential challenge which I solve. Specifically, one needs exogenous variation in entrepreneurs' social networks that is caused neither by the venture's business opportunities nor the unobserved characteristics of entrepreneurs. Without a setting that captures such variation, it is hard to isolate the effect of social networks on advantages such as access to venture financing from other factors that simultaneously affect the advantage and tie formation.

My approach is to exploit intra-entrepreneur variation of ties to venture capitalists: an entrepreneur often approaches several VC firms for funding and usually does not have previous ties with all of them. Using this variation, combined with entrepreneur level fixed-effects enables me to directly study how social ties affect the chances of gaining a VC's attention. One key advantage of this method is that it rules out the possibility that the observed network effect can be explained by entrepreneur or firm level characteristics that may influence tie formation and VC attention at the same time.

Using a unique dataset collected through fieldwork in China, I find that an entrepreneur is more likely to gain an interview offer from a connected VC firm as opposed to one from outside the entrepreneur's network. However, evidence also suggests that firms benefiting from social ties in the first stage are less likely to be selected for funding in the second stage. These results imply that social bonds impose constraints upon VCs in granting interviews as they are influenced, indeed sometimes even coerced, to interact with some firms that they might not otherwise investigate.

These empirical results raise an interesting question regarding the balance of obligations in economic transactions (Heimer 1992; Portes 1998). These can be simultaneously obligations to perform tasks in a universal way (being professional, maximizing organizational efficiency and selecting the most promising startups to invest) and obligations to behave responsibly in one's relations to particular network partners (being "humane", fulfilling friendship duties and providing favorable treatment to a friend's venture). This balance of obligations may even shape the evolution of social networks. When "doing favors" becomes so time consuming that it threatens the execution of professional tasks, investors have to make calculations regarding the number of favors to give, to whom and at what time.

In "Bureaucracy and Entrepreneurship under Market Transition", I explore how work experiences shape an entrepreneur's capability to access and utilize key economic resources in growing his firm's competitiveness.

The fact that bureaucrats enjoyed large economic advantages over the rest of the society is an extremely robust empirical finding in the context of state-controlled economies. However, the literature has no consensus regarding the capability of bureaucrats to retain these advantages during market transition. There are at least two schools of thoughts. The elite retention theory argues that former cadres can rely on connections and administrative expertise acquired under state socialism to maintain high economic status in the post-socialist era (Stark 1990; Rona-Tas 1994). However, the market transition theory has argued that cadres will lose their advantages due to the decline of the state's redistributive power in the emergence of a market society (Nee 1989). A recent literature has particularly argued that "the realities of bureaucratic life are fundamentally incompatible with the development of entrepreneurial initiative" (Sorensen, 2007), suggesting bureaucrats-turned-entrepreneurs perform poorly.

While the prior literature has categorically defined bureaucracy as either being good or bad for entrepreneurial endeavors, my research aims to reconcile these perspectives. I argue that, rather than being all of one piece, a bureaucratic organization is a career location with a multiplicity of factors influencing entrepreneurial opportunity and competence. Thus, work experience in the state sector can have very different implications for individuals' willingness to embrace new ventures, their commitment as entrepreneurs, and their ventures' performance in terms of access and utilization of resources. While bureaucracy constrains people from developing entrepreneurial mindset and skills (Sorensen, 2007; Sorensen and Philips, 2008), this does not necessarily deny that it can help entrepreneurs gain legitimacy and access external resources (Baum and Oliver, 1991; Malesky and Taussig, 2008).

Using a nationally representative survey of private entrepreneurs in China, I find that, compared with entrepreneurs whose careers did not include time in the state sector, bureaucrats-turned-entrepreneurs are more likely to access key external resources such as bank credit and to grow their firms to larger sizes in terms of revenue. However, bureaucratic experiences also have a detrimental effect, as firms of bureaucrats-turned-entrepreneurs do not utilize resources efficiently and suffer from productivity losses.

My findings suggest that bureaucracy presents entrepreneurs with a double-edged sword: On the one hand, affiliation with established players helps firms build legitimacy and access external resources. Given their size and prominence, bureaucratic organizations tend to occupy central positions within an organizational ecosystem. Affiliation with such organizations may serve as a social capital, helping certify entrepreneurs as legitimate players and connect them directly or indirectly to key resource holders that might otherwise have hesitate to collaborate with these entrepreneurs. On the other hand, bureaucratic work environment exposes employees to inefficient organizational routines, and influence employees to learn sluggish organizational culture. When these factors are transferred to a new organization through employee turnover, the progeny organization suffers in performance. Thus, the issue is not to measure the net positive or negative effects of bureaucracy but rather the mechanisms that produce these negative and positive effects and to highlight the role of institutional context.

A follow-up study further provides evidences that entrepreneurs transfer organizational genes from one workplace to another. Among 270 high-tech startup firms in central China, it is more likely to find bureaucratic characteristics in firms founded by entrepreneurs with work experience in the state sector. For instance, their top management teams are more likely to be overstaffed and featured with more tiers of hierarchy. In addition, these entrepreneurs tend to engage in a “local search” for venture partners: their top management teams are more likely to be staffed by people from the local community and by people that they have strong social ties with. This indicates that prior workplace shapes an entrepreneur’s networking opportunities and consequentially the social structure of his management team.

Institutional Drivers of Entrepreneurship

Beyond the two papers described above, my dissertation also aims to understand the relationship between institutional context and entrepreneurs' choice of organizational form. My paper "Institutional Constraints" (coauthored with Yasheng Huang) particularly looks at the foreign direct investment (FDI) seeking behavior of private entrepreneurs in China. We challenge the notion that the prevalence of FDI indicates the host country's institutional strength in protecting private enterprises. We argue that international joint venture formed through FDI is an ownership arrangement that helps Chinese entrepreneurs to change the political status of their ventures and thus enables them to avoid being politically discriminated. To be more specific, we argue that there is a political pecking order in the Chinese economic system: while domestic private enterprises are located at the bottom of the hierarchy and are denied access to secure property rights and key economic resources controlled by state agencies, foreign invested enterprises are ranked much higher and are granted with various preferential policy treatments that are off limits to domestic firms (Huang 2003). As this political pecking order is ownership based, FDI represents an opportunity for private entrepreneurs to change their firms' political status through the formation of international joint ventures.

Leveraging the wide variation of the institutional environment across Chinese regions, we test the argument above using a nationally representative sample of non-state owned enterprises. We find that the same set of institutional factors that constrain local firm development also drive Chinese entrepreneurs' eagerness to absorb foreign direct investments. Particularly, FDI-seeking behaviors are most likely to happen in regions where the policy differential toward domestic and foreign enterprises is the largest. We argue that, although preferential policies toward foreign-invested enterprises put domestic enterprises into a relatively disadvantaged position, they also create opportunities for local entrepreneurs to dodge the otherwise constraining institutional environment. Even though it was not originally designed to serve this purpose, we can see from this perspective that China's FDI policy essentially helps liberalize the domestic economic sector.

Conclusions

These three essays, while covering a wide range of outcome variables, have a common theme: in a developing country like China where market-supporting institutions are underdeveloped, entrepreneurs have to rely on non-market strategies for their ventures' survival and growth. However, these strategies do not come without a cost - for venture capitalists, while social ties transfer "soft information" that reduces investment uncertainty and risks, these ties also enact social obligations that constrain the investors' flexibility and induce them to interact with under-qualified entrepreneurs whom they would not have considered for interviews without social pressures. For (potential) entrepreneurs, while work experience in the public sector helps them develop connections with governmental agencies and enables them to access state controlled resources, such a career path also exposes these individuals to inefficient organizational routines and bureaucratic cultures that prevent them from utilizing resources efficiently. For private enterprise owners, while foreign enterprise status helps them to overcome domestic political discrimination, this forces them to split firm ownership without necessarily being compensated with technological/managerial knowhow as in the case of a typical international joint venture. In combination, these three essays suggest that, while nonmarket strategies help entrepreneurs alleviate institutional voids in developing countries, these strategies have intrinsic limitations and the improvement of formal institutions are required in order to fully unleash the force of “creative destruction” .

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